United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

76-6175

10/17

To be argued by
MICHAEL C. DEVINE

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P/S

IN THE

United States Court of Appeals

For the Second Circuit

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

against

COMMONWEALTH CHEMICAL SECURITIES, INC., *et al.*,

Defendants-Appellants.

On Appeal from the United States District Court for the Southern District of New York

REPLY BRIEF FOR DEFENDANTS-APPELLANTS

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POINT I

THE DISTRICT COURT'S CLEARLY ERRONEOUS FACT FINDINGS ARE DEFENDED IN APPELLEE'S BRIEF BY NOTHING MORE THAN INFERENCE, INFORMAL PRESUMPTION, MERE POSSIBILITY, AND RANK SPECULATION

Appellants' main brief demonstrates the clear error of the district court's findings of fact. In defense of those findings, appellee's brief stacks speculations upon inferences, with constant repetition of "might have been", "could have", "presumably", and phrases of like import. The question which must be answered, separately as to each individual appellant, is simply--does appellee's brief identify any properly admitted evidence which may be said to support the district court's findings? The answer is NO.

(1) Marlane Kleinman. Mrs. Kleinman's name was not mentioned at the trial. The only documentary reference to her is on a chart prepared by the SEC, showing a small purchase and sale of Beneficial Labs units through Merrill Lynch Pierce Fenner & Smith.

Appellee's brief is unable to point to anything else--anything that might be considered evidence. In a footnote (#51, pg. 46) it tries to shift the burden of proof to Mrs. Kleinman, arguing that from her failure to testify the

court can infer that the allegations of the complaint are true. But our courts traditionally have held plaintiffs to a higher standard of proof. Appellee cites no authority for the novel proposition that the SEC need only offer its complaint and thereupon shift the burden to the defendant to prove innocence.

About Mrs. Kleinman appellee's brief argues such vagaries as: "her transactions 'more or less coincided with the manipulations..." (p. 46); she "...must have known of the fraudulent scheme.'" (p. 46); she was "...in a position to know of the illegal scheme,..." (p.48); and she "...should have known of the scheme to defraud,..." (p.49). And what are the record references to support these flights of fancy? Not one. Not a single reference to a single statement of a single witness. Not a single reference to a single word in a single document.

The grave danger in permitting the SEC a "special litigant" status, in permitting it to obtain injunctions with a burden of proof lighter than that required of private litigants, is grimly exemplified by the SEC's continuing insistence upon the need for, much less its right to, an injunction against Mrs. Kleinman.

(2) Julius Kleinman. Here again, appellee's brief utterly fails to give any record references (to testimony or documentary evidence) which could support the findings of the district court. In this instance appellee uses a ploy often

repeated in its brief--it attempts to support the findings of the district court by references to the court's own opinion. Appellants ask only that the district court's findings be tested against the record, and not against speculations and possibilities.

Examples demonstrate appellee's inability to point out any real evidence against Mr. Kleinman. At page 14 of its brief appellee states "...the court found that the twelve accounts controlled by Messrs. Drucker and Kleinman, and Commonwealth and DK & B 'participated in about 70% of all transactio..s...".

No record references are given in support of the contention that Mr. Kleinman "controlled" twelve accounts. The only reference is to the district court's own opinion. No references are given because none exist. At trial the closest appellee came to proving that Mr. Kleinman controlled any account (other than his own) was the testimony of Regina Sinofsky, who simply said that Mr. Kleinman made investment decisions for the account--not that he had any beneficial interest in it. Investment advice is not "control", but even if it were, Mr. Kleinman would have been shown to have controlled only two accounts, not twelve.

Another example of the failure of proof is revealed on page 21 of appellee's brief where reference is made to the district court's finding that Mr. Kleinman had acted in a conflicting role "in placing large blocks of Beneficial

securities with the funds". Again the only reference is to the district court's own opinion. The only evidence even remotely relating to this issue is the testimony of Mr. Wolff (an admitted perjurer) who said that Mr. Kleinman called him to confirm an order by Vanguard Fund of 5,000 shares of a stock other than Beneficial; i.e., stock of something called "EDI". There is no evidence of any order by Mr. Kleinman of Beneficial stock.

Other examples could be given. This Court's review of the record will reveal the failure of proof against Mr. Kleinman. Appellee now seeks to avoid the consequences of its failure of proof by attempting to shift the burden of proof, arguing that the allegations of the complaint may be deemed proved if the defendant does not testify (see appellee's brief, p. 29)--the same argument which appellee made in trying to side step the failure of proof against Mrs. Kleinman. In neither instance can it suffice; in neither instance can it constitute a substitute for evidence.

(3) Mary Sharpe. At trial appellee proved that Miss Sharpe purchased for her mother 1000 units of the Beneficial Labs offering, and that she subsequently sold 500 of the 1000 units. These facts certainly do not constitute a violation of any securities law, and appellants' main brief on this appeal in effect challenges appellee to show (with record references) proof of some deception or scheme perpetrated by Miss Sharpe. Appellee's response

(brief, pp. 45-46) is to quote the district court opinion (without any record references), which in essence states that Miss Sharpe is to be enjoined because she was Commonwealth's "bookkeeper" and because of the "timing" of her purchase. Yet she purchased in the public offering, at the same "time" as all other initial public investors, and a "bookkeeper" is not subject to any stricter regulation than any other investor. Additionally, Miss Sharpe purchased on the advice of counsel.

Thus appellee once again is unable to point out evidence which could support the flights of speculation which the district court engaged in to hold appellants liable.

(4) Robert Drucker. In discussing Mr. Drucker appellee elevates use of the word "presumably" and phrases like "could have been" to an art form. For instance, appellants have argued that the Beneficial Labs offering was not undersold, as proved in part by the fact that the closing on the offering occurred ten days early. To rebut this, appellee, at page 29 of its brief, states that "...this could have been part of the scheme to disguise the failure of the offering,...." (emphasis supplied). "Could have been" is not evidence.

Again, on the very next page (appellee's brief, p. 30), where the subject is an alleged after-market manipulation, more rank speculation is offered in place of proof. Appellee asserts that "...the price rises seem inexplicable in the absence of manipulation..." (emphasis supplied). Appellee offers no authority for the extraordinary proposition

that a "seemingly inexplicable" price rise is synonymous with manipulation. The drastic consequences, and inappropriateness, of any such concept are too apparent to require comment.

Then on page 36 of appellee's brief, in discussing the alleged manipulative effect of an alleged stock "swap", appellee states that it "...might have had the effect of contributing to a further increase in prices..." (emphasis supplied).

Additionally, there is the repeated use of "presumably", an all-purpose proof substitute (emphasis supplied):

> --"Many of these transactions were presumably designed to take large blocks of Beneficial securities out of circulation,..." (brief, p. 35).
>
> --"...presumably designed to create the appearance of active trading in Beneficial securities...." (brief, p. 36).
>
> --"...records that presumably are more accurate and more complete than the monthly statements appellants might have received..." (brief, p. 63).*

And as with all of the other appellants, appellee turns to inferences to bolster its speculations. On page 26 of its brief appellee asserts that defendants' failure to call Mr. Massad as a witness allows an inference that Mr. Massad's testimony would have been adverse to defendants. The truth is that Mr. Massad was beyond subpoena range, and had not been

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*In a footnote (#72) appellee's brief speculates even further with respect to these monthly statements, stating that the court "might well have determined" that they were inaccurate.

deposed by defendants. The SEC had an investigative transcript of Mr. Massad's testimony, but failed to offer any portion of it at trial. If any inference is to be drawn, it should be against appellee, which had not only the burden of proof, but also the transcript.*

Beyond inference and speculation appellee's brief also contains false characterizations of the record. For instance, at page 2 of its brief appellee asserts that the price of Beneficial stock "doubled within a few days after the closing". In fact, the Beneficial units commenced trading on Friday, March 10, 1972 (the closing date of the offering), at between $2 and $3. (PX10; 94a). On Monday, March 13, 1972, they still traded in that range, and there appear (by the SEC's charts) to have been no further trades for over two weeks, until March 30, 1972.

Similarly, on page 19 of its brief appellee suggests that Hedge Fund and Vanguard Fund had invested 60% and 20% of their assets, respectively, in Beneficial securities. In fact, Hedge Fund and Vanguard Fund purchased Beneficial securities at relatively low prices, and at the time of the purchases those securities did not represent anything near 60% or 20% of the portfolios. Later, as the price of Beneficial securities rose,

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*In similar inferential style, appellee's brief (at p. 40 ; fn. # 42) assumes that appellants are conceding certain of the district court's conclusions of law. This of course is not the fact. Appellants submit that each and every adverse conclusion of the district court is erroneous.

and the funds had the benefit of the appreciation in their value, those blocks came to represent larger percentages of the portfolio, but that was solely the result of investment success. Appellee's suggestion of initial investments of 60% or 20% is materially misleading.

Finally, in assessing the sufficiency of the evidence against Mr. Drucker the district court did not give consideration to the fact that Mr. Drucker acted with the advice of counsel. This is pointed out in appellants' main brief, and it is verified by appellee's brief, which refers to the presence of attorneys and makes no effort to lessen the role they played.

> "...good faith reliance on advice of counsel may be a factor to consider in deciding whether to grant injunctive relief,..." SEC v. E.L. Aaron & Co., Inc., CCH Fed. Sec. L. Rep. ¶96,043, at 91,686 (SDNY, 1977).

In short, appellants' main brief elaborates on the failure of proof in this action, that which the district court referred to as an "incoherent" and "incomprehensible" presentation, and appellee's brief fails to respond with any record references which support the findings of fact. The speculations and inferences relied upon are plainly unreliable and insufficient.

POINT II

APPELLEE FAILED TO PROVE ANY REASONABLE LIKELIHOOD OF RECURRENCE

An absolute prerequisite to issuance of an injunction in an SEC action is positive proof of a likelihood that the defendant's allegedly unlawful behavior will recur. A mere possibility is not sufficient. These propositions recently have been reemphasized by this Court.

> "It is well settled that the Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrongdoing will recur." SEC v. Bausch & Lomb Inc., slip op. 41, 61 (2d Cir. Sept. 30, 1977).
>
> * * *
>
> "The Commission cannot obtain injunctive relief where there is no reasonable likelihood of recurrence." SEC v. Parklane Hosiery, 558 F.2d 1083 (2d Cir. 1977).

(1) Marlane Kleinman and Mary Sharpe. One searches in vain in appellee's brief for a record reference to some "positive proof" that Mrs. Kleinman and Miss Sharpe are likely to violate the securities laws in the future. Almost unbelievably, appellee is content in this regard to rely upon the district court's facile suggestion that there "is no reason to

believe that, should a similar opportunity arise in the future, they would shy away." (appellee's brief, pp. 46-47). Such hypothetical negative speculation certainly is not what this Court has described as "positive proof". The burden is not on the defendant to show that she would "shy away"; it is on the SEC to show "more than a mere possibility" of recurrence. Miss Sharpe still is a bookkeeper, never before or since even remotely or tangentially in contact with the SEC. Mrs. Kleinman is a wife. She is not now, and was not at the time of the events alleged, even remotely or tangentially in contact with the SEC or the securities industry.

If these ladies validly can be enjoined on this record the "positive proof" and "more than mere possibility" standards have no meaning.

(2) Julius Kleinman. Apparently cognizant of its inability at trial to prove a likelihood of recurrence, the SEC, in its brief on this appeal, has resorted to outright false statement. On page 44 of its brief it states that Mr. Kleinman was preliminarily enjoined in SEC v. Drucker, SDNY, #76 Cir. 2643 (MEL). The truth is that Mr. Kleinman was not even named in that action, much less preliminary enjoined.*

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*Appellee's brief also (at p. 44) alleges SEC administrative sanctions against Mr. Kleinman in the Salmon matter. Here again the truth is that that proceeding was settled, without litigated findings, for practical reasons that need not be elaborated for this Court.

In fact, Mr. Kleinman is out of the securities business, and has been for several years. He has had no contact with the SEC or the securities industry since the business of Commonwealth Chemical Securities terminated in 1973.

Thus the "positive proof" offered with respect to Mr. Kleinman is not only not in the record, it is blatantly false.

(3) Robert Drucker. Not surprisingly, the record made at the trial of this action contains absolutely no evidence, much less "positive proof", of any likelihood of future violations by Mr. Drucker. In this instance, rather than resort to false statement, appellee has resorted to material omission. On page 44 of its brief it states that Mr. Drucker was preliminarily enjoined in SEC v. Drucker, 76 Civ. 2643 (MEL), but it omits a full explanation of the circumstances under which a preliminary injunction purportedly was entered. No hearing was conducted, and the understanding of Schwenke & Devine (counsel for Mr. Drucker in that action) is that the preliminary injunction, if ever entered, was entered erroneously, Judge Lasker believing that it had been consented to. In any event, no trial has occurred, no evidence has been submitted, and no findings have been made. After the record has been closed, the SEC cannot seek to supplement it, and prove propensity, by making subsequent, unproven allegations against the defendant. Other than this

misstated, highly prejudicial,* reference to a subsequent, untried action, appellee is unable to show anything remotely resembling "positive proof" relative to Mr. Drucker.

Mr. Drucker has had no contact with the securities business subsequent to termination of the operations of Commonwealth Chemical Securities in 1973.

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*Strenuous exception is taken to another effort by appellee to prejudice the deliberations of this Court. On page 67 of its brief appellee refers to an untried indictment against Mr. Drucker. The tactic is indicative of lengths to which appellee apparently believes it must go.

POINT III

THE DISTRICT COURT ERRONEOUSLY HELD APPELLANTS LIABLE WITHOUT MAKING ANY FINDING OF SCIENTER -- A REQUIRED ELEMENT OF THE COMMISSION'S PROOF IN THIS ACTION WITH RESPECT TO EACH APPELLANT.

This Court has just recently observed that in view of the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), "whether scienter is ... a necessary predicate for injunctive relief" is open in this Circuit. SEC v. Bausch & Lomb Incorporated, slip op. 41, 52 (2d Cir. Sept. 30, 1977).*

The conclusion reached by Judge Ward in Bausch & Lomb, that scienter is a necessary element in an injunctive action brought by the Commission, has been joined in other recent district court decisions. See SEC v. American Realty Trust, CCH Fed.

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* This issue has also been recognized as existing but unresolved in the District of Columbia. See Collins Securities Corporation v. SEC, CCH Fed. Sec. L. Rep. ¶96, 122, at p.92, 046 (D.C. Cir. 1977); SEC v. Wills, CCH Fed. Sec.L. Rep. ¶96, 102 (D.D.C.1977).

Sec.L. Rep. ¶95, 913, pp. 91, 439-40 (E.D. Va. 1977) (involving, as does the instant action, alleged violations of Section 17 of the 1933 Act as well as Section 10(b) of the 1934 Act); SEC v. Cenco Inc., CCH Fed. Sec.L. Rep. ¶96, 133 (N.D. Ill. 1977).

We submit that the failure of the district court to make a finding of scienter as to any of the appellants requires reversal. The issue is directly presented on this appeal -- since the Commission's brief, with respect to appellants Mary Sharpe and Marlane Kleinman, concedes that their liability was imposed based on a "negligence" standard. (See SEC Brief, pp.48-54)

CONCLUSION

The injunctions issued in this action must be vacated because the SEC utterly failed to produce "positive proof" of a "likelihood of recurrence" of the violations alleged. The record is barren of any such "positive proof".

Want of findings of "scienter", and lack of a jury trial, mandate at minimum reversal and remand.*

Yet reversal is warranted most by the failure of proof, a pervasive lack of evidence papered over with inference and conjecture. Appellee's brief strings together a series of "might have been's", and the same speculations are at the heart of the district court's findings.

> For all sad words of tongue and pen,
> The saddest are these: "It might
> have been!"**

Subsequent to Ernst & Ernst v. Hochfelder, 425 U.S 185 (1976) there has been a general reexamination of the standard of proof which the SEC must satisfy in seeking serious

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*Appellee's brief concedes the need for a remand for recalculation of ancillary relief, admitting the unreliability of the information upon which the ancillary relief was calculated.

**From "Maud Muller"; John Greenleaf Whittier.

sanctions. See Collins Securities Corp. v. SEC, _____F.2d_____; CCH Fed. Sec. L. Rep. ¶ 96,122 (D.C. Cir. 1977). Side by side with that reexamination is a growing judicial awareness of the long-lasting and dire consequences of an SEC injunction too lightly imposed. An SEC injunction deprives the defendant of his livelihood, described by the D.C. Circuit as a "heavy sanction" and a "severe sanction". (See Collins, supra, at pp. 92,044 and 92,045). Deprivation of one's livelihood is truly a punishment, as our courts increasingly are prone to recognize.

> "While we do not question the validity of the nature of the sanctions imposed in this case, we do believe that their imposition renders that proceeding quasi-criminal in nature. While we do not go so far as to require the Commission to meet the criminal law's standard of proof "beyond a reasonable doubt," we do believe that the preponderance standard is not consistent with the quasi-criminal nature of the proceeding. The standard of proof to which the agency is held must in some substantial measure be commensurate with the arsenal of sanctions available to the agency; in this case, the standard of "clear and convincing evidence" serves this function of drawing a realistic correlation between the burden of persuasion and the available remedies." Collins, supra, at 92,045.

The foregoing portion of the Collins decision speaks to SEC administrative sanctions, but the quasi-criminal consequences are even more demonstrable when dealing with injunctions rather than administrative orders.

In recognition of the destructive potential of the SEC's arsenal the Collins decision reevaluated the applicable

standard of proof and determined to replace the so-called "preponderance" standard with the more rigorous "clear and convincing" standard.

In the present action it is not necessary to alter the standard of proof governing SEC injunctive actions; all that is necessary is a hard and penetrating look at the record, for it will reveal evidence insufficient by any standard to sustain the injunctions here imposed.

Respectfully submitted,

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Of counsel:

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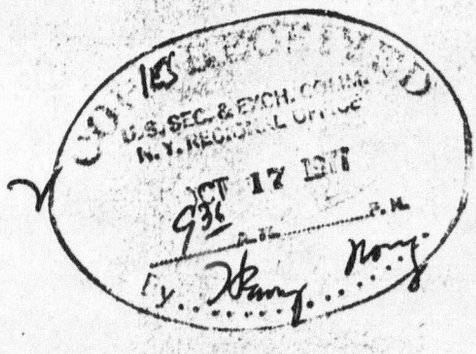
Service of 2 copies of the
within Brief is hereby
admitted this 17th day of
Oct 1977

Signed _____

Attorney for Plaintiff-Appellee



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